Vítor Constâncio: In defence of monetary policy

Opinion piece by Mr Vítor Constâncio, Vice-President of the European Central Bank, 11 March 2016.

* * *

This week the ECB adopted new measures to reinforce its monetary policy in the face of recent headwinds. That decision was taken against a backdrop of vocal scepticism in the media and markets. The sceptics' reasoning is two-pronged. First, that monetary policy is not sufficient to address the present low growth trend; and second, that monetary policy is increasingly ineffective in any case.

The notion that monetary policy alone cannot raise trend growth is mostly true but trivial, especially if the challenges of secular stagnation highlighted by Robert Gordon in his brilliant new book are considered.

The G20 has appealed for the use of other policies, notably fiscal and structural reforms. While other policies would certainly be welcome, one can have justified doubts about their implementation. For a start, active stabilising fiscal policy is restricted by law in the EU and by politics in the US. More generally, countries that could use fiscal space, won't; and many that would use it, shouldn't.

That leaves us with structural reforms. Some, like upgrading education and judicial efficiency, are important but take a long time to implement and to produce results. The structural reforms economists often have in mind (i.e. liberalization and deregulation of markets) lead to lower wages and prices in the short-term, which does not help inflation normalisation. And concerning unemployment, higher productivity often initially implies labour saving. Structural reforms are essential for long-term potential growth, but it is difficult to see how they could spur growth significantly in the next two years, especially when the current problem is lack of global demand.

And as regards their delivery by governments, we should recall the embarrassing results of the G20 plan agreed in Brisbane to generate an additional 2% in world growth via a long concrete list of reforms put forward by the IMF and the OECD. In fact, the world economy now risks not even attaining what was then considered the baseline scenario.

So if these other policies either can't or won't contribute to a significant degree, then not only is it wrong to start talking down monetary policy – it's actually dangerous. The second criticism of monetary policy is mostly based on a crude comparison between where inflation (or growth) is now and where it was at the beginning of the policy. The conclusion: inflation didn't change much, so the policy isn't working. However, what is rational and essential is to examine what would have happened had the policy not been adopted in the first place. Using several models, ECB staff estimated that, without our policies, inflation would have been a third of a percent negative in 2015 and would have stayed significantly negative throughout 2016, which would mean that we would have been in permanent deflation since last year. This is a significant result. Recall that the final outcome was affected by the unexpected decline in the price of oil by 30% from September to December.

We estimate that two thirds of one percent of the registered growth in the past two years was due to our monetary policy. However, what we achieved in fostering internal demand was undone by the subsequent decrease of net exports in a decelerating world economy. These developments did not make our policy less effective, only ex-post insufficient for the desired outcome.

Naturally, all policies have limits. In the case of the instruments we are now using, this is particularly true of negative interest rates on our deposit facility. The reasons are more fundamental than just the effect on banks[1].

Despite negative rates throughout last year, the net interest income (NII) of euro area banks increased in percentage of assets, and their return on equity went up from 3.5% in 2014 to 5.7% in 2015 – which corresponds to a real return as inflation was zero. Our policies also produced capital gains for banks, as securities' prices went up (and yields down), and impairment costs came down as the recovery reduced the amount of NPLs. More broadly, negative deposit facility rates have contributed to negative rates in the money market, reducing funding costs for banks. The whole yield curve has been lowered, which is the sole objective of using this particular monetary policy instrument.

To normalise inflation in the euro area we urgently need higher growth that can reduce negative output and unemployment gaps, using all really available policies. If not monetary policy, then what?

1 See Cecchetti & Schoenholtz (2016) How Low Can They Go?